

EXCEPTION



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ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission
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BEFORE THE ARIZONA CORPORATION COMMISSION

16 IN THE MATTER OF THE
17 APPLICATION OF ARIZONA WATER
18 COMPANY, AN ARIZONA
19 CORPORATION, FOR ADJUSTMENTS
20 TO ITS RATES AND CHARGES FOR
21 UTILITY SERVICE FURNISHED BY
22 ITS EASTERN GROUP AND FOR
23 CERTAIN RELATED APPROVALS.

Docket No. W-01445A-02-0619

**ARIZONA WATER COMPANY'S
EXCEPTIONS TO RECOMMENDED
OPINION AND ORDER**

24 Arizona Water Company ("Arizona Water" or "the Company") hereby submits its
25 exceptions to the recommended opinion and order ("ROO") filed on January 2, 2004
26 pursuant to A.A.C. R14-3-110(B). Arizona Water respectfully submits that, in summary,
the ROO is erroneous in the following respects:

(1) There is no legitimate reason to eliminate the Company's purchased power
and purchased water adjustment mechanisms. These mechanisms, which have been in
place for approximately 20 years on a company-wide basis,¹ benefit both the Company

¹ Arizona Water supplies water utility service to approximately 70,000 customers in eight Arizona counties under 18 separate water systems. This rate proceeding involves only the Company's Eastern Group, which serves approximately 29,000 customers in Apache Junction, Bisbee, Miami, Oracle, San Manuel, Sierra Vista, Superior and Winkelman.

1 and ratepayers by passing on both increased and decreased costs of power and water.
2 The existence of these adjustment mechanisms does not provide a disincentive for the
3 Company to obtain the lowest possible cost because power and water cannot be
4 purchased on a competitive basis and only a portion of the increased cost is passed on to
5 customers. Moreover, the Company has no control over the rates it must pay to purchase
6 power and water.

7 (2) The authorized rate of return on the shareholder's common equity, 9.2%, is
8 substantially less than the authorized, realized and forecasted returns on equity of the
9 sample groups of water and natural gas utilities used by the parties. Putting aside the
10 various technical arguments made by the parties, the authorized rate of return must be
11 commensurate with the returns earned by enterprises with comparable risks (the
12 comparable earnings standard). *E.g., Federal Power Comm'n v. Hope Natural Gas Co.*,
13 320 U.S. 591, 603 (1944); *Bluefield Waterworks & Improvement Co. v. Public Serv.*
14 *Comm'n*, 262 U.S. 679, 692-93 (1923). An authorized return on equity of only 9.2%
15 would violate that standard.

16 (3) In the ROO, Staff's proposed inverted-block rate design is properly rejected
17 as inequitable and inconsistent with the type of inverted-block rate design approved by
18 this Commission in other cases. However, the ROO goes on to require Arizona Water to
19 implement an alternative form of inverted-block rate design without any supporting
20 evidence or analysis of the impact of that rate design on customers' water usage or the
21 Company's revenues. This rate design was not advocated by any party to this case. In
22 reality, this rate design, like Staff's proposal, would shift a substantial portion of the
23 Company's revenue requirement to customers on larger-sized meters, discriminating
24 against those customers and violating basic cost-of-service principles.

25 (4) Under the ROO, Arizona Water's tariff for the delivery of non-potable
26 Central Arizona Project ("CAP") water in Apache Junction, known as the NP-260 tariff,

1 would be modified to eliminate the meter charge and associated depreciation expense.
2 Under this modification, the Company would be allowed to recover only the amounts
3 paid to the Central Arizona Water Conservation District for raw CAP water. In other
4 words, the Company would not be allowed to recover any of the administrative and
5 billing expenses that must be incurred to provide service. At the same time, however, the
6 Company's test year revenues have not been adjusted downward to remove the revenues
7 that the Company collected under the existing meter charge. Thus, under the ROO, the
8 expenses associated with the NP-260 tariff will not be recovered in rates, and instead
9 shifted to the shareholders. Either the Company should be allowed to recover these
10 expenses from the customers receiving CAP water, or the revenues resulting from the
11 tariff should be removed.

12 (5) The ROO would confiscate one-half of a payment received as part of a
13 settlement negotiated in 1997 by the Company with a group of mining companies, known
14 as the Pinal Creek Group ("PCG"), by deducting one-half of those proceeds -- \$700,000 -
15 - from the Miami system's rate base. None of the parties contends that the Company
16 acted imprudently in protecting its interests and the interests of its Miami system
17 customers in negotiating the PCG settlement. Moreover, the key component of the
18 settlement is the requirement that the PCG provide a guaranteed supply of water through
19 2028. The ROO ignores the benefits provided by this settlement, which include avoided
20 capital costs, estimated to be between \$5 million and \$17 million, and avoided operating
21 expenses, estimated to be \$150,000 per year. The bottom line is that the settlement
22 substantially lowers customers' rates for service while ensuring a dependable supply of
23 water. There is no basis to penalize the Company by refusing to allow it to recover a
24 return on \$700,000 of utility plant when it has achieved significantly greater savings for
25 its Miami system customers.

26 Each of the foregoing errors is addressed in detail below.

1 In addition, the Company has discovered two computational errors relating to the
2 recovery of the recommended level of rate case expense and the proposed rates for Sierra
3 Vista. The ROO proposes recovery of rate case expense of \$250,000, amortized over
4 three years. The Company is not challenging that recommendation. However, in
5 analyzing the ROO, the Company discovered that rate case expense is understated by
6 \$29,987 per year, a total of \$89,961 over the recovery period. This computational error
7 affects the Apache Junction (\$24,523 per year) and Bisbee (\$5,464 per year) systems. A
8 schedule illustrating this error is attached at Tab A. It appears that the Administrative
9 Law Judge inadvertently used Staff's rate case expense amounts for those two systems,
10 rather than the amounts resulting from his recommendation.

11 The rates proposed for the Sierra Vista system on Exhibit D of the ROO will not
12 produce the level of revenues recommended in the ROO. A schedule which provides the
13 correct rates is attached at Tab B.

14 **A. The Company's Purchased Power and Purchased Water Adjustment**
15 **Mechanisms Should Not Be Eliminated.**

16 The ROO would eliminate the Company's long-standing purchased power
17 adjustment mechanism ("PPAM") and purchased water adjustment mechanism
18 ("PWAM") without any legitimate basis or claimed benefit. PPAM and PWAM were
19 originally approved by the Commission in Decision No. 53537 (April 27, 1983) and
20 Decision No. 55069 (June 13, 1986), respectively, and have been in effect for 21 and 18
21 years, respectively. Moreover, in Arizona Water's recent rate case for its Northern Group
22 water systems, neither Staff nor any other party challenged the appropriateness of the
23 Company's adjustment mechanisms. (Decision No. 64282 (Dec. 28, 2001).)

24 Given that the Company's adjustment mechanisms have been in effect for
25 approximately 20 years, are known to work well, and have not been an issue in its two
26 most recent rate cases, it is surprising that Staff would challenge them at this time. There

1 has not been any change in circumstances that would justify revisiting these longstanding
2 adjustment mechanisms. In fact, last July, Arizona's largest electric utility, Arizona
3 Public Service Company ("APS"), which provides electric service to five of the eight
4 Eastern Group water systems, filed a general rate case for the first time in more than a
5 decade, creating a substantial likelihood that the Commission will authorize APS to
6 increase rates, **thus** causing the Company's purchased power expense to increase later
7 this year after this case has concluded. Nevertheless, and despite recognizing that the
8 PPAM and PWAM benefit both the Company and its customers, the ROO states that
9 "adjustment mechanisms may also provide a disincentive for the Company to obtain the
10 lowest possible cost commodity because the costs are simply passed through to
11 ratepayers." (ROO at 13, ls. 24-26.) This statement is not, and cannot be, supported by
12 the evidence in this case. Moreover, the design of the existing adjustment mechanisms
13 includes a built-in incentive, as explained in Decision No. 55069, at page 20:

14 We still believe that AWC should have a PPAM, and it
15 should be based on gallons pumped and not gallons sold.
16 We recognize that this will not allow AWC to fully collect
increased power costs but believe that this will serve as an
incentive for AWC to minimize costs.

17 The cost of electric power is determined either by the Commission (in the case of
18 an electric utility such as APS) or by the governing board (in the case of an unregulated
19 service provider). In either case, the Company has no control over the rates and charges
20 it must pay. Similarly, the rate for water purchased by the Company's San Manuel
21 system is set by BHP Copper. (Ht. at 318-321.) The Company has no control over these
22 costs, and there is no evidence that lower cost alternatives are, or ever will be, available.²
23 Thus, the PPAM and PWAM provide no disincentive to obtain the lowest possible cost
24 because there are no alternatives available and Arizona Water cannot control the rates for

25 _____
26 ² In fact, with respect to water for the San Manuel system, the uncontroverted evidence
shows that Arizona Water is already utilizing the least cost water supply. (Ht. at 318-21.)

1 power and water.

2 The ROO also states there is no evidence in the record that purchased power or
3 purchased water costs are a “significant” portion of the Company’s expenses or are
4 “volatile.” (ROO at 13, l. 26 – 14, l. 1). These conclusions are erroneous. First, Staff’s
5 assertion that adjuster mechanisms may only be authorized for “significant” or “volatile”
6 operating expenses is entirely unsupported. In fact, there has been no indication that the
7 costs of purchased power and water are any more or less significant or volatile than they
8 were at the time the Commission initially approved the adjustment mechanisms
9 approximately 20 years ago.

10 Second, the Legislature has specifically required the Commission to authorize
11 water utilities to implement adjustment mechanisms to recover certain operating
12 expenses. A.R.S. § 40-370. The operating expenses that are subject to recovery “are
13 limited to specific, readily identifiable costs that are subject to the control of another
14 person, including the cost of purchasing electricity or gas, [and] the cost of purchasing
15 water” A.R.S. § 40-370(A)(emphasis supplied). Thus, the most important criteria
16 are whether the expense is incurred in connection with purchasing an essential
17 commodity and whether the Company has control over the rate or charge for that
18 commodity, and not whether it is significant or volatile.

19 Third, as a matter of policy, Staff’s highly restrictive criteria make no sense.
20 Putting aside the Legislature’s direction, the Commission has previously recognized that
21 the Company’s PPAM and PWAM benefit ratepayers by reducing the need for rate cases.
22 (Decision No. 58120 at 30-31.) This benefit has been realized repeatedly over the past
23 several years because the PPAM has allowed the Company to pass on cost savings due to
24 reductions in rates and has enabled the Company to defer rate proceedings (the last rate
25 proceeding for the Eastern Group systems was over 10 years ago). (Hubbard Rb. (Ex. A-
26 12) at 18.) Given the significant time and costs necessary to complete a rate case, and the

1 fact that adjustment mechanisms like the PPAM and PWAM are income-neutral,
2 providing benefit to both utilities and their customers, use of adjustment mechanisms is
3 sound regulatory policy. For all of these reasons, the PPAM and PWAM for the
4 Company's Eastern Group systems should be left in place.

5 **B. An Authorized Rate of Return on Equity of 9.2% is Unreasonably Low**
6 **When Compared to Actual Returns on Equity for Publicly-Traded**
7 **Water Utilities.**

8 In the ROO, Staff's unadjusted cost of equity, 9.2%, would be adopted as the
9 return on equity for Arizona Water. Putting aside the technical arguments made by the
10 witnesses regarding the appropriateness of their respective models, the cost of equity
11 estimates presented by Staff, which form the basis for the 9.2% recommendation in the
12 ROO, are simply not consistent with recent authorized returns on common equity,
13 realized returns on common equity, and *Value Line's* forecasted returns on common
14 equity of publicly-traded water utilities. These data clearly show that a 9.2% return on
equity is simply too low:

	<u>Authorized ROE</u>	<u>Realized ROE</u>	<u>Value Line Forecast</u>
16 2001	10.86%	10.27%	11.00%
17 2002	10.62%	10.58%	10.50%
18 2003	10.59%	10.60%	11.00%
19 Average	10.69%	10.48%	10.83%

20 (Zepp Rb. (Ex. A-5), Rebuttal Table 1.) These data are consistent; there are no wild
21 swings up or down, and there is no indication that authorized or realized rates of return
22 will dramatically decline. In the Company's Northern Group rate case, the Commission
23 authorized a return on equity of 10.25%, for rates that became effective on January 1,
24 2002. (Decision No. 64282 at 19.) Although somewhat lower than the authorized,
25 realized and forecasted returns on equity for the water utility sample, above, that return is
26 nevertheless 105 basis points (1.05%) greater than the 9.2% return recommended for the

1 Company here. There is no explanation in the ROO for this dramatic decrease.

2 In contrast, the estimates of the current cost of equity produced by Staff's models,
3 using data from its sample group of publicly traded water utilities, are biased downward,
4 and, with one exception, are substantially less than the authorized, realized and forecasted
5 returns on equity for those utilities:

6 **Staff Cost of Equity Estimates**

7	DCF (Constant Growth)	8.5%
8	DCF (Multi-Stage)	9.6%
9	CAPM (Historic Risk Premium)	7.7%
10	CAPM (Current Risk Premium)	11.1%
11	Average	9.2%

12 (Reiker Dt. (Ex. S-38) at 25 and Schedule JMR-7.) Thus, with the exception of Staff's
13 CAPM estimate that utilizes a current market risk premium, all of the results of Staff's
14 models are substantially below what an investor would logically expect based on actual
15 data and forecasts from a widely-followed investment service.³

16 In contrast, the results produced by Dr. Zepp's models are consistent with recent
17 authorized, realized and forecasted returns on equity for the sample group of publicly
18 traded water utilities. Dr. Zepp's updated estimates using the DCF and the risk premium
19 methods of estimating the cost of equity, presented in his rebuttal testimony, are as
20 follows:

21 **Dr. Zepp's Cost of Equity Estimates**

22	DCF	10.8%
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23
24 ³ The equity cost produced by Mr. Reiker's basic CAPM model, 7.7%, is equal to the
25 forecasted interest rate on Baa utility bonds. (Zepp Rj. (Ex. A-7) at Rejoinder Table 1.)
26 Moreover, the model used by Staff's cost of capital witness have a history of producing
returns on equity that are substantially below his sample group's actual and authorized
returns, as shown by Hearing Exhibit A-27, indicating that his models are biased
downward.

1	Risk Premium (Past Water Utilities' ROEs)	11.0%
2	Risk Premium (Forecasted Cost of Baa Bonds)	11.2%
3	Average	11.0%

4 (Zepp Rb. (Ex. A-5) at 8-9, Update Tables 16, 22 and 25.)

5 In sum, the parties' witnesses have generally employed established methods of
6 estimating the cost of common equity. See, e.g., Charles F. Phillips, Jr., *The Regulation*
7 *of Public Utilities*, at 394-399 (summary of approaches commonly used to estimate the
8 cost of equity). Regardless of the method used, however, it should produce results that
9 are consistent with what utilities are actually earning. As Mr. Meek testified, "simple
10 common sense indicates that something is wrong with the model when it produces results
11 that low," in discussing Staff's basic DCF and CAPM estimates. (Meek Rb. (Ex. A-8) at
12 5.) Ultimately, the model must be judged against reality. Otherwise it will not produce
13 results that satisfy the attraction-of-capital and comparable earnings standards the United
14 States Supreme Court and Arizona appellate courts have established. In this case, only
15 the Company's cost of equity estimates meet those standards.

16 **C. The Inverted Block Rate Structure in the ROO is Unsupported by the**
17 **Record, is Inconsistent with Cost-of-Service Principles and**
18 **Discriminates Against Customers on Larger-Size Meters.**

19 The Company's proposed rate design in this case follows the same principles as
20 the rate design approved by the Commission in Decision No. 64282 (Dec. 28, 2001) for
21 the Company's five Northern Group water systems. The Eastern Group's existing rates,
22 like those of the Northern Group, are based on a cost of service study presented in the
23 Company's 1992 rate case. (Kennedy Rb. (Ex. A-16) at 15.) Under this rate design, the
24 Company has a monthly minimum charge that increases based on meter size and a single
25 commodity rate for all gallons sold. (Kennedy Dt. (Ex. A-15) at 17.) This rate design is
26 fair, easy for customers to understand, simple to administer and produces predictable
revenue. (Garfield Rb. (Ex. A-2) at 20.) See American Water Works Association,

1 *Alternative Rates 22-26* (1992) (“the primary objectives in instituting uniform volume
2 rates are that the single price per unit is readily understood by the consumer, and at the
3 same time, conveys the message that additional water consumption is equally as
4 expensive as initial volumes of water.”).

5 Staff, in contrast, proposed to radically change the Company’s rate design by
6 implementing a “lifeline rate,” i.e., a discounted commodity rate applicable to the first
7 3,000 gallons used each month. All customers, regardless of type of use, meter size,
8 income, or other specific characteristics, would automatically receive this discounted
9 rate. (Thornton Dt. (Ex. S-40) at 2.) Staff’s lifeline rate would discourage water
10 conservation and would result in a significant subsidy, which would be recovered, under
11 Staff’s proposal, by a third commodity rate block applicable to all gallons in excess of
12 50,000 gallons per month, again regardless of the type of customer or any other specific
13 characteristics. According to Staff this inverted-block rate design will not promote water
14 conservation. In fact, the Staff rate design witness testified that water is “price inelastic,”
15 and that “water use changes little with a three-tiered rate design.” (Thornton Dt. (Ex. S-
16 40) at 6.)

17 The ROO recognizes the various defects in Staff’s proposal, and appropriately
18 rejects that proposal. The ROO nevertheless would require Arizona Water to implement
19 an inverted-block rate structure, with increasing commodity rates as follows: First tier –
20 to 10,000 gallons per month; second tier – 10,001 to 25,000 gallons per month; and third
21 tier – over 25,000 gallons per month. (ROO at 26, ls. 23-end.) This recommendation is
22 unsupported by the record and inappropriate for several different reasons.

23 First, much like Staff’s flawed proposal, which the ROO rejects, this rate design
24 fails to consider any differences between the Company’s water systems as well as
25 between customers on varying meter sizes. Thus, a residential customer on a 5/8-inch
26 meter in Bisbee is treated the same as a commercial customer on a 4 inch meter in

1 Apache Junction. This disregards differences in cost of service. As explained by the
2 American Water Works Association:

3 Inverted rate schedules would not likely be appropriate for
4 all customer classes. Some large-volume commercial and
5 industrial customers have very uniform water-use patterns
with a resultant lower unit cost of service than residential
customers.

6 A very practical objection to inverted rates is that higher use
7 per customer does not necessarily indicate a higher cost per
8 unit of use. Thus only in special circumstances could
9 inverted rates be considered as cost-of-service related. Such
circumstances should be documented and carefully evaluated
before inverted rates are proposed.

10 American Water Works Association, *Water Rates* 50 (4th ed. 1991).

11 In this case, a break point of 25,000 gallons will result in many commercial and
12 industrial customers, including hospitals and schools, paying more for service, regardless
13 of their ability to conserve. Again, this is contrary to basic rate design principles:

14 The adverse impact of inverted-block rates on large-volume
15 customers is an essential consideration. Depending on the
16 existing rate form, the adoption of inverted-block rates can
17 have substantial negative financial impacts on such
customers. The degree of impact should be understood as
should possible reactions by those customers.

18 * * *

19 The development and implementation of an inverted-block
20 rate structure requires a full billing analysis and a study of
the impacts on various customers. An analysis of possible
consumption and revenue impacts should also be undertaken.

21 American Water Works Association, *Alternative Rates* 19 (1992). For this reason, water
22 utilities that have implemented inverted-block rate structures have taken into account
23 customer type, meter size and other distinguishing characteristics in developing an
24 appropriate rate design.

25 The rate design in the ROO discriminates against customers on larger-sized
26 meters. Only 5% of test year water use by all Eastern Group customers on a 5/8-inch

1 meter would fall in the upper rate block. (Exhibit at Tab C.) Conversely, almost 82% of
2 test year water usage by customers on 2-inch meters would fall in the upper rate block,
3 while over 93% of test year water usage by customers on 3-inch and larger-sized meters
4 would fall in the upper rate block. (*Id.*) However, no analysis of the impact of this rate
5 design on those customers was performed and no party supported this rate design.
6 Further, although the intent of this rate design is, presumably, to reduce water use, with a
7 corresponding revenue decrease, the ROO makes no adjustment in the Company's
8 revenues to take into account the impact of reductions in water use. The Proposed
9 Annual Revenues in the ROO (Exhibit C., line 10) will not be realized if the inverted-tier
10 rates have their intended conservation effect.

11 In short, the ROO appropriately rejects Staff's simplistic inverted-block rate
12 design, which, as Staff has acknowledged, will not encourage water conservation.
13 Unfortunately, the ROO would require Arizona Water to adopt a variation of this rate
14 design, which discriminates against customers on larger-sized meters and creates revenue
15 instability and uncertainty. But most importantly, there is no cost of service study,
16 detailed billing analysis or other evidence in the record supporting this new rate design.
17 Accordingly, the Commission should reject the rate design in the ROO and instead
18 approve Arizona Water's proposed rate design, just as it did two years ago when it
19 rejected Staff's unsupported inverted block rate design in the Company's Northern Group
20 rate case.

21 **D. The NP-260 Tariff Should Not Be Modified.**

22 The Company's NP-260 Tariff for its Apache Junction system is designed to allow
23 recovery of all of the actual costs of providing non-potable water service (the delivery of
24 untreated CAP water), including administrative and billing costs, directly from the
25 customers taking such service. In this way, the tariff provides a small safety margin to
26 ensure that this service is not subsidized by general service customers. Nevertheless, the

1 ROO adopts several changes to the Company's current NP-260 Tariff, including
2 eliminating the meter charge component of that tariff. (ROO at 30.) These modifications
3 are unnecessary and would prevent the tariff from recovering the cost of service.

4 First, the ROO's reliance on the Commission's decision in the *SLV Properties*
5 matter, Decision No. 65755 (March 20, 2003), is misplaced. (ROO at 30-31.) While the
6 Commission directed Staff to review the Company's NP-260 Tariff in that decision, the
7 Commission obviously expected Staff to demonstrate why any changes to the tariff are
8 necessary. However, there is no citation to the Commission's decision to support the
9 specific modifications to the NP-260 Tariff recommended in the ROO, nor is there
10 anything in Decision No. 65755, which dismissed SLV's complaint against the Company
11 and authorized recovery of all accrued late charges and related taxes, that evidences the
12 alleged problems raised by Staff and accepted in the ROO.

13 Moreover, elimination of the meter charge component of the NP-260 Tariff
14 removes the means by which the Company recovers its administrative and billing costs.
15 Accordingly, there must be an offsetting adjustment to the general service rates and
16 charges in order to ensure that the Company's costs of service are recovered if the
17 recommendations in the ROO are adopted. However, no such adjustment is made in the
18 ROO. Consequently, the Company would be required to subsidize the cost of delivering
19 non-potable CAP water if the recommendation in the ROO were adopted. Given that the
20 Company is required to provide this service, and that the maintenance fees and related
21 charges under the NP-260 Tariff were approved as reasonable by the Commission in
22 Decision No. 65755, modification of the tariff to eliminate the meter charge should not be
23 approved absent a compelling reason. No such reason has been offered in this case.
24 Furthermore, if the meter charge is to be eliminated, an adjustment to the general rates for
25 service would be necessary if the Company is to recover its actual costs of service.

26

1 **E. The Recommended Treatment of the PCG Settlement Is Confiscatory.**

2 The ROO's proposed treatment of the PCG Settlement would confiscate \$700,000
3 of investor-funded plant by removing it from the Miami system's rate base. This is
4 necessary, according to the ROO, to allow ratepayers to share equally in the proceeds of
5 the PCG Settlement. (ROO at 34.) However, there is no PCG-financed plant in the
6 Miami system rate base. Moreover, it is undisputed that ratepayers have and will receive
7 the lion's share of the benefits realized from the PCG Settlement in the form of a
8 guaranteed supply of 600 gpm of water beyond 2028. The ROO ignores the benefits
9 provided by the settlement, which include avoided capital costs, estimated to be between
10 \$5 million and \$17 million, and avoided operating expenses, estimated to be \$150,000
11 per year. Therefore, depriving the Company of any return on unrelated but prudently
12 invested plant is confiscatory. Utilities like Arizona Water should be commended for
13 undertaking efforts that lower customers' rates for service while ensuring a dependable
14 supply of water, not penalized by refusing to allow a return on \$700,000 of utility plant.

15 By way of brief background, in 1997, the Company learned that the State of
16 Arizona was about to enter into a consent order concerning the contamination of
17 groundwater in the Miami area by the members of the PCG, a consortium of mining
18 interests. (Garfield Rb. (Ex. A-2) at 7.) Arizona Water took immediate steps to intervene
19 in the PCG matter before the State finalized its settlement agreement with the PCG,
20 which would have foreclosed the Company's ability to seek any compensation from the
21 PCG for harm to the Company's water supplies, including certain decreed water rights
22 the Company owns. (Garfield Rb. (Ex. A-2) at 7.) After nearly eight months of litigation
23 in federal court and negotiations with the PCG, the PCG Settlement was reached. Had
24 Arizona Water not taken the actions it did, at its risk and expense, the Company and its
25 Miami system customers would have realized none of the benefits of the settlement. (Ht.
26 at 287-88; Garfield Rj. (Ex. A-3) at 9.)

1 The PCG Settlement is best viewed as providing Arizona Water and its Miami
2 system customers a basket of benefits. (Ht. at 288, 562, 694.) The key component of the
3 PCG Settlement is the requirement that the PCG provide Arizona Water a guaranteed,
4 stable supply of water, 600 gpm as of 2003 and continuing through 2028. (Garfield Rb.
5 (Ex. A-2) at 10; Kennedy Rb. (Ex. A-15) at 4.) In addition, the Company received a \$1.4
6 million dollar payment in exchange for its agreement to waive and release its then
7 pending claims against the PCG for losses, damages and liabilities. (Exhibit S-1; Ht. at
8 276-77; Garfield Rebuttal (Ex. A-2) at 9-10.) The ROO, however, fails to assign any
9 value to the benefit of a guaranteed and stable supply of water provided by the PCG
10 Settlement, benefits that accrue entirely to the Miami System customers. In reality, this
11 benefit has significant value to ratepayers, and that value can, in significant part, be
12 quantified. (Kennedy Rb. (A-16) at 5-7; Kennedy Rj. (Ex. A-17) at 10-12.) First, there is
13 the avoided revenue requirement for the additional wells the Company would have been
14 required to drill, equip and operate but for the water supply provided by the PCG, an
15 estimated benefit to the customers in the range of \$5 million to \$17 million over the life
16 of the PCG Settlement. *Id.* Second, the operating expenses associated with providing
17 water to Miami system customers are substantially lower, as much as \$150,000 per year,
18 as a result of the PCG Settlement. Third, the water supply for the Miami system is more
19 reliable as a result of the PCG Settlement, substantially reducing the likelihood of outages
20 and associated water use restrictions. Fourth, access to the PCG water supply has
21 reduced the likelihood that the Company will need to construct water treatment facilities.
22 Even on a very conservative basis, customer benefits are at least **four times** the value of
23 the payment to the Company.

24 The foregoing notwithstanding, the ROO would punish Arizona Water by
25 eliminating \$700,000 of its investment in utility plant by reducing its rate base. The
26 ROO concludes that this confiscation of the Company's investment is justified because

1 the Company has an obligation to obtain and provide an adequate source of water for its
2 customers and because the Company is being allowed to include \$308,000 of legal
3 expenses in rate base. (ROO at 34-35.) Neither reason supports the confiscation of
4 Arizona Water's property.

5 The replacement water component that must be provided under the PCG
6 Settlement was obtained because Arizona Water, at its own risk and expense, succeeded
7 in negotiating a settlement agreement with the PCG. The Company, having taken that
8 risk and succeeded in obtaining this water supply, has surely met its obligation. Yet,
9 rather than reward the Company for its actions, the ROO would punish the Company by
10 reducing its rate base by \$700,000. Such a result does not produce an equitable
11 allocation of the benefits of the PCG Settlement.

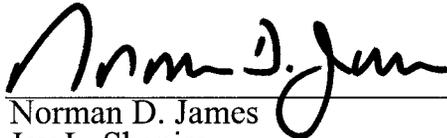
12 The second reason for the ROO's recommendation, the inclusion of \$308,000 in
13 rate base, likewise fails to support confiscating \$700,000 of the Company's rate base.
14 First, there is no dispute that the Company expended that amount to obtain the settlement.
15 Second, the Company acted to protect decreed water rights that have been in existence
16 for more than 100 years, rights that have benefit beyond the results of the PCG
17 Settlement. (HT at 547.) Third, the amount of return the Company will realize on the
18 cost of protecting those water rights (about \$30,000 per year) is inconsequential when
19 compared to the benefits from the PCG Settlement realized by ratepayers as a result of
20 the Company's actions.

21 In short, Arizona Water incurred the expense and took the risk associated with
22 intervening in the PCG litigation and obtaining a settlement. The Company has already
23 allocated the benefits realized under the PCG Settlement in an equitable manner by
24 providing, conservatively, more than 80% of the measurable present value of the
25 settlement package to the Miami customers in the form of reduced rates. (Ht. at 562.)
26 The fees and expenses Arizona Water incurred to obtain these benefits should be

1 included in rate base because they were also necessary to protect decreed water rights
2 owned by the Company. Under these circumstances, it would be inequitable and
3 confiscatory to now deprive the Company of its fair share of the PCG Settlement by
4 deducting any portion of the settlement payment from the Miami system rate base.

5 RESPECTFULLY SUBMITTED this 21st day of January, 2004.

6 FENNEMORE CRAIG

7
8 By 
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14 Attorneys for Applicant
15 Arizona Water Company

16 An original and 13 copies of the
17 foregoing were delivered this 21st day of
18 January, 2004 to:

19 Docketing Supervisor
20 Docket Control
21 Arizona Corporation Commission
22 1200 West Washington
23 Phoenix, AZ 85007

24 A copy of the foregoing was hand-delivered this 21st
25 day of January, 2004 to:

26 Chairman Marc Spitzer
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner William Mundell
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Mike Gleason
Arizona Corporation Commission
1200 W. Washington St.

- 1 Phoenix, AZ 85007
- 2 Commissioner Jeff Hatch-Miller
3 Arizona Corporation Commission
4 1200 W. Washington St.
Phoenix, AZ 85007
- 5 Commissioner Kristin Mayes
6 Arizona Corporation Commission
7 1200 W. Washington St.
Phoenix, AZ 85007
- 8 Paul Walker, Aide to Chairman Spitzer
9 Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007
- 10 Adam Stafford, Aide to Commissioner Mundell
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- 21 Dwight Nodes, Assistant Chief Administrative Law Judge
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2 A copy of the foregoing was mailed this 21st
3 day of January, 2004 to:

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16
17 By: Mary A House

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A

Arizona Water Company
 Eastern Group
 Rate Case Expense
 2001 Test Year

Line	Description	Total Eastern Group	Apache Junction	Bisbee	Sierra Vista	Miami	San Manuel	Oracle	Winkelman	Superior
1	Company's Adjusted TY Level of A&G ¹	1,862,416	896,828	235,785	158,596	246,728	107,529	104,590	13,395	98,965
Rate Case Expense Included in TY Level of A&G:										
2	Total Expense Requested in Company's TY A&G	\$ 257,550	133,946	29,847	20,516	30,353	12,422	14,614	1,742	14,108
3	Annual Amortization (3-year period) ²	\$ 85,851	44,649	9,949	6,839	10,118	4,141	4,871	581	4,703
ROO Recommended Rate Case Expense:										
4	Recommended Total Rate Case Expense	\$ 250,000	130,020	28,972	19,915	29,463	12,058	14,186	1,691	13,695
5	Annual Amortization (3-year period)	\$ 83,333	43,340	9,657	6,638	9,821	4,019	4,729	564	4,565
6	Adjustment to A&G - Rate Case Expense	\$ 2,518	1,309	292	201	297	122	142	17	138
7	Disallowance for Charitable Contributions ³	\$ 14,722	7,667	1,704	1,171	1,733	709	834	99	805
8	Correct Adjustment to A&G	\$ 17,240	8,976	1,996	1,372	2,030	831	976	116	943
9	A&G Adjustment per Exhibit C of ROO	\$ 47,227	33,499	7,460	1,372	2,030	830	977	116	943
10	Overstatement of Adjustment in ROO ⁴	\$ 29,987	24,523	5,464	0	0	(1)	1	0	0

¹Source: Company Direct Line 11 of Schedule C-1

²Source: Company Direct Pro Forma Adjustment No. 16 Schedule C-2

³Source: Staff Direct Operating Income Adjustments-Charitable Contributions

⁴To correct the error, Administrative and General Expenses increase resulting in a corresponding increase in revenue requirement for the two affected systems. i.e. Apache Junction's revenue requirement should increase \$24,523 and Bisbee's revenue requirement should increase \$5,464.

B

Error In Calculation of Proposed Rates for Sierra Vista System

The rates proposed on Exhibit D of the ROO for the Company's Sierra Vista system will not generate the Proposed Annual Revenues of \$1,145,850, on Exhibit C, Line 10 of the ROO (\$1,132,237 after removing Other Revenue). Notwithstanding changes recommended in the Company's Exceptions to the Recommended Opinion and Order, the correct rates for the Sierra Vista system should be:

Monthly Usage Charge:

5/8" X 3/4"	\$15.40
1"	32.71
2"	125.47
3"	284.64
4"	398.10
6"	604.72
8"	725.66
10"	907.08

Commodity Rates:

Per 1,000 Gallons (In Excess of Minimum)	N/A
Per 1,000 Gallons for 0 to 10,000 Gallons	\$ 1.6120
Per 1,000 Gallons for 10,000 to 25,000 Gallons	\$ 2.0150
Per 1,000 Gallons for Gallons in Excess of Gallons	\$ 2.4180

C

ARIZONA WATER COMPANY
 Percentage of Consumption by Meter Size - Eastern Group
 Eastern Group Rate Case
 Test Year 2001

Line System	5/8"			1"			2"			3"			4"			6"		
	1st Block	2nd Block	3rd Block	1st Block	2nd Block	3rd Block	1st Block	2nd Block	3rd Block	1st Block	2nd Block	3rd Block	1st Block	2nd Block	3rd Block	1st Block	2nd Block	3rd Block
1 Apache Junction	77.16%	17.42%	5.42%	28.09%	19.63%	52.28%	6.84%	9.28%	83.88%	2.34%	3.35%	94.31%	1.13%	1.68%	97.19%	1.41%	2.10%	96.49%
2 Superior	83.13%	13.38%	3.49%	25.08%	24.69%	50.22%	15.89%	14.68%	69.44%	3.92%	5.88%	90.20%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
3 Bisbee	81.19%	15.08%	3.73%	35.88%	26.98%	37.14%	12.03%	15.00%	72.97%	0.00%	0.00%	0.00%	3.58%	5.36%	91.06%	0.00%	0.00%	0.00%
4 Sierra Vista	69.03%	23.58%	7.39%	37.52%	27.95%	34.53%	8.00%	10.88%	81.11%	1.64%	2.47%	95.89%	2.71%	4.07%	93.22%	0.00%	0.00%	0.00%
5 Miami	82.05%	14.26%	3.69%	31.83%	22.32%	45.85%	8.57%	10.46%	80.97%	4.45%	6.68%	88.87%	1.04%	1.56%	97.41%	1.05%	1.58%	97.36%
6 San Manuel	67.57%	25.53%	6.90%	31.07%	26.93%	42.00%	7.19%	9.08%	83.74%	10.76%	16.14%	73.10%	4.29%	6.44%	89.27%	3.22%	4.07%	92.71%
7 Oracle	88.92%	9.94%	1.15%	56.29%	21.10%	22.61%	9.20%	12.39%	78.42%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	17.88%	25.63%	56.49%
8 Winkelman	69.73%	22.80%	7.46%	23.55%	30.55%	45.90%	12.09%	17.68%	70.23%	2.60%	3.86%	93.54%	1.19%	1.79%	97.02%	0.00%	0.00%	0.00%
9 Eastern Group	76.95%	17.84%	5.22%	30.77%	21.45%	47.79%	7.83%	10.26%	81.91%	2.53%	3.67%	93.80%	1.32%	1.98%	96.70%	1.47%	2.18%	96.34%

Note: Arizona Water Company has approved rates for 8-inch and 10-inch meter sizes, but does not serve any customers on those meter sizes.